



# PRICE REVIEW 2013: GREATER METROPOLITAN WATER BUSINESSES

Draft Decision – Executive Summary

April 2013



# SUMMARY OF DRAFT DECISION

## BACKGROUND — THE PRICE REVIEW PROCESS

In October 2012, the Essential Services Commission (the Commission) commenced its formal review of the Victorian water businesses' proposals for the five year regulatory period: 1 July 2013 to 30 June 2018.

Under the price review process, the greater metropolitan water businesses submitted Water Plans setting out the expected costs of delivering water, sewerage and other services, their planned capital works programs, the forecast volumes of water that will be delivered and the levels of service to be delivered to customers. Each business also proposed prices that would raise the revenue required to recover its expected costs over the regulatory period. The water businesses were required to consult their customers when developing their Water Plans.

Consultation with stakeholders is also an important part of the Commission's price review process. To inform water businesses and their customers of its expectations regarding the water planning process, the Commission released a guidance paper in October 2011. In November 2012, it released a paper summarising the businesses' proposals and highlighting issues on which it sought stakeholder comments. The Commission received over 50 submissions. In addition, during November and December 2012 the Commission held public meetings around the State at which the water businesses presented their proposals. Customers and community and business groups had the opportunity to respond.

The Commission also formed a Customer Reference Panel. The panel includes consumer and business representative groups as well as individual customers. It provided the Commission with its views on the issues that its members consider important for the price review.



This draft decision is the next stage in the Commission's consultation process. It sets out the Commission's views on whether the prices proposed by the businesses satisfy the pricing principles set by the Victorian Government. The relevant businesses are:

- Melbourne Water
- City West Water
- South East Water
- Yarra Valley Water
- Western Water.

Interested parties now have a further opportunity to comment on the Commission's approach and proposed decisions. These views will inform the Commission's final decision to be released in June 2013. Written submissions are due by 20 May 2013:

The Commission would prefer to receive submissions by email at:  
[water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)

You can also send comments by mail to:

Water Team

Essential Services Commission

Level 37, 2 Lonsdale Street

Melbourne VIC 3000

The Commission will hold further public meetings on 30 April (Melbourne) and 1 May (Frankston). There is a forum for Western Water on 30 April (Sunbury). Details will be advertised and published on the Commission's website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)).

## CONTEXT AND KEY ISSUES

This assessment relates to the five year regulatory period for the greater metropolitan water businesses, commencing 1 July 2013. Price Reviews are conducted in accordance with the *Water Industry Regulatory Order* (WIRO) issued by the Minister for Water. The WIRO was last updated in 2012 (chapter 1). It sets out the regulatory approach that the Commission is required to adopt when reviewing Water Plans, including the principles that are relevant to the Commission's assessment. Consequently, water businesses are expected to submit plans that are consistent with the matters set out in the WIRO. The



Commission also issued guidance notes to inform the development of Water Plans. Among other things, the Commission required that the Water Plans should be informed by robust analysis, thorough consultation and reasonable assumptions about the future.

While the second regulatory period (2008-13) was overshadowed by a period of drought that resulted in major investments in new sources of water supply, the third regulatory period (2013-18) will see reduced spending reflecting the completion of this investment phase.

The key issues for this price review include:

- price impacts on customers, particularly in light of the already substantial increase in prices over the past five years. A major cost driver in the third regulatory period will be the commencement of payments for the desalination plant which was formally commissioned on 17 December 2012.
- ensuring water businesses continue to deliver services valued by customers and improve efficiency.
- understanding customers' expectations and their willingness to pay for different service offerings.

Specific concerns raised by customers, and community and business groups include:

- the impact of past and proposed price increases, particularly a vulnerable and low income customers
- whether any price increases should be 'smoothed' over a number of years rather than implemented as a one-off step increase in 2013-14
- the mix of fixed and variable water charges and the consequences for different customer groups such as tenants (who directly pay the variable charge)
- expectations that service levels should at least be maintained and
- the manner in which the costs associated with the desalination plant will be reflected in prices.

In its guidance material, the Commission stated that it would also take a narrower view of noncontractual obligations; that is, it would exclude from allowed revenue the costs of alleged but unclear obligations. The Commission found there were few claims for such projects in the Water Plans.



## THE COMMISSION'S APPROACH

As noted, the WIRO sets out the regulatory approach that the Commission is required to adopt in assessing the prices and revenues proposed in the businesses' Water Plans. In order to approve the prices proposed in a Water Plan, the Commission is required to be satisfied that those prices are sufficient to:

- generate a business's revenue requirements that allow it to meet the efficient costs of delivering services to customers, taking into account the interest of customers
- ensure the business's financial viability, including a reasonable return on capital, and
- reflect the costs of balancing supply and demand and provide incentives for customers and signals about sustainable water use.

In applying these principles, the Commission focused on ensuring that prices are as low as possible but still sufficient to recover the businesses' efficient costs of providing services. In approving tariff structures, the Commission has had regard to aligning prices with underlying costs as well as to the expressed interests of customers.

In reaching its draft decision, the Commission assessed whether each business's proposed expenditure is efficient and prudent, its capital works program is deliverable over the regulatory period, and its business strategy is consistent with its objectives over a longer term planning horizon. The Commission also assessed whether it was prudent and efficient to defer some expenditure into the following regulatory period.

This draft decision outlines the Commission's approach to each element of the businesses' Water Plans. All supporting material is provided on the Commission's website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)), including the Commission's guidance documents, each business's Water Plan, independent consultants' assessments of the key elements of Water Plans, fact sheets and summaries of the Commission's decision for each water business.

Unless otherwise specified, all values shown in this draft decision and supporting material are nominated in \$2012-13, that is, the Commission have excluded the effects of inflation.



## DRAFT DECISION OUTCOMES

### SERVICE STANDARDS

Service standard targets (chapter 4) proposed by the metropolitan water businesses and Western Water for the coming regulatory period generally reflect historical performance achieved by the businesses over the previous five years. The Guaranteed Service Levels proposed by the businesses remain largely unchanged from the second regulatory period.

### REVENUES

In their Water Plans, the businesses' identified their revenue requirements for the third regulatory period (2013-18). These revenue forecasts reflect their expected operating expenditure, a return on assets (existing and new assets) and regulatory depreciation (return of assets).

Melbourne Water sought revenue totalling \$8611.9 million. The Commission proposes to allow revenue of \$8123.0 million, this is \$488.9 million (or 5.7 per cent) lower than Melbourne Water's proposal (table 1).

For the purpose of this draft decision, the Commission has used the cost proposed by Melbourne Water in relation to the desalination plant (table 1). The Commission's consideration of desalination costs is discussed below.

**TABLE 1 MELBOURNE WATER'S PROPOSED REVENUE REQUIREMENT COMPARED TO DRAFT DECISION**  
\$m 2012-13

	Proposed by business	Draft decision	Difference	
			(\$m)	(per cent)
Revenue requirement excluding desalination costs	5 569.1	5 154.7	-414	-7.4
Desalination costs	3 042.8	2 968.3	-74	-2.4
<b>Total revenue requirement</b>	<b>8 611.9</b>	<b>8 123.0</b>	<b>-489</b>	<b>-5.7</b>

**Note:** Melbourne Water charges the retailers for services (and to a lesser extent Western Water), to recover its revenue requirement.

The other four water businesses covered in this draft decision (City West Water, South East Water, Yarra Valley Water and Western Water) sought combined

revenues totalling \$13 059.3 million over the next five years. The Commission's draft decision results in a lower revenue for the water businesses of \$12 265.7 million. This is \$793.6 million (or 6.1 per cent) lower than that proposed by the businesses (table 2).

**TABLE 2 PROPOSED REVENUE REQUIREMENTS**  
\$m 2012-13

	<b>Proposed by business</b>	<b>Draft decision</b>	<b>Difference</b>	
	<i>(\$m)</i>	<i>(\$m)</i>	<i>(\$m)</i>	<i>(per cent)</i>
City West Water	3 157.2	2 926.1	-231.1	-7.3
South East Water	4 560.5	4 283.4	-277.1	-6.1
Yarra Valley Water	4 936.6	4 697.8	-238.8	-4.8
Western Water	405.1	358.4	-46.7	-11.5
<b>Total retail businesses</b>	<b>13 059.3</b>	<b>12 265.7</b>	<b>-793.6</b>	<b>-6.1</b>

**Note:** The three metropolitan retailers charge end-use customers for services to recover their revenue requirements. In turn, the retailers pay Melbourne Water for bulk water and sewerage services.

This downward adjustment to the water businesses' proposed revenue reflects the Commission's assessment of the efficient costs of delivering services. The major areas of adjustments to the businesses' costs the Commission proposes to make, include:

- lower financing costs
- operating expenditure reductions for areas such as labour, energy and licences
- required productivity improvements
- reduced or deferred capital programs
- Melbourne Water's revised estimates for desalination costs.

By way of comparison, in the last price review, the Commission approved \$5494.0 million for Melbourne Water and \$8634.4 million for the four water retail businesses. Revenue requirements are discussed more fully in chapter 5.



## DESALINATION COSTS (CHAPTERS 6 AND 21)

The proposals from Melbourne Water and the water retailers in relation to the treatment of costs relating to the desalination plant is a significant driver of the proposed price increases in the third regulatory period.

The plant will provide two main services:

- a security service — if other sources of water become constrained, it will be ready and capable of producing water. Melbourne Water incurs an annual security payment irrespective of whether water is order from the plant; and
- a water supply service — whereby up to 150 gigalitres per year of water is produced and delivered to Melbourne Water. A water supply charge is paid in line with the water received by Melbourne Water.

Melbourne Water has proposed that it will pass through in full (via its bulk charges) the security payment it incurs in each year of the regulatory period. In turn, the water retailers have proposed that they recover these costs directly and in full from customers.

While this arrangement means that the amount recovered from end-use customers reflects Melbourne Water's security payments (which it is contractually obliged to pay), it does not necessarily take into account whether the stream of costs borne by customers matches the stream of benefits they receive. The security payments reflect a 27 year contractual payment profile, after which Melbourne Water will take ownership of the plant. It is expected to have a further 23 year operating life. In other words, the proposed arrangements imply that customers over the next 27 years will pay for a facility that will provide benefits for at least 50 years.

Based on the evidence before it, the Commission is not satisfied that the proposed prices meet the requirements of the WIRO by taking into account the interests of customers (including low income and vulnerable customers) or by providing appropriate incentives and signals to retailers and end-use customers.

Further, the Commission is not satisfied that Melbourne Water has undertaken adequate consultation with the metropolitan retailers or end-use customers. The Commission is concerned that the metropolitan retailers have not made adequate representation on behalf of, or in the interests of, their customers.

The Commission requires Melbourne Water to resubmit its proposal for the recovery of its desalination security costs, including an assessment of other available options. The Commission encourages all relevant parties to work together in developing a response to this draft decision. Chapter 21 outlines the matters that the Commission considers need further attention.



## **OPERATING EXPENDITURE (CHAPTER 7)**

The Commission proposes to approve \$4850.7 million of operating expenditure for Melbourne Water over the next five years. This is \$201.6 million (or 4.0 per cent) lower than that Melbourne Water proposed. As indicated earlier, the key adjustments include lower financing costs, meeting the Commission's required productivity improvement and lower allowances for energy and labour.

For the other greater metropolitan water businesses, the Commission proposes to approve \$9221.0 million over the same period. This is \$481.7 million (or 5.0 per cent) lower than they proposed.

## **CAPITAL EXPENDITURE (CHAPTER 8)**

The Commission proposes to approve \$2409.1 million of capital expenditure for Melbourne Water over the next five years. This is \$48.0 million (or 2.0 per cent) lower than Melbourne Water proposed.

For the other four businesses, the Commission proposes to approve \$3192.2 million. This is \$136.4 million (or 4.1 per cent) lower than that proposed by the businesses.

The Commission's revised capital expenditure allowance reflects its proposed changes to the timing of delivery of projects and the removal of some projects.

## **FINANCING COSTS (CHAPTER 9)**

Based on current market conditions, the Commission proposes to approve a real post tax weighted average cost of capital of 4.7 per cent. This is lower than the 5.1 per cent that applies in the current regulatory period.<sup>1</sup>

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<sup>1</sup> The WACC applied in the current regulatory period to Western Water and Melbourne Water's drainage and waterways revenue requirements is 5.8 per cent.



## PRICES

The Commission is responsible for approving the maximum prices each water business can charge its customers in each year during the outlook period.

As a result of proposed downward revision to the water businesses' expenditure and revenue requirements, the Commission proposes maximum price increases that are less than those proposed by each of the water businesses.

Excluding the impact of inflation, the price increases over five years proposed by the four greater metropolitan water businesses (City West Water, South East Water, Yarra Valley Water and Western Water) ranged from 31.7 per cent to 35.8 per cent. Much of this increase reflected Melbourne Water's proposed bulk services (wholesale) price increase of 59.9 per cent. Following the adjustments made by the Commission, these price increases have been moderated. The Commission proposes to approve price increases that range from 5.9 per cent for Western Water, to 20 per cent to 26 per cent for the metropolitan retailers (table 3). These retail price increases incorporate the Commission's proposed decision to reduce Melbourne Water's bulk services price increase to 47.6 per cent. As noted above, for the purposes of this draft decision, the Commission has used Melbourne Water's proposal to recover fully the desalination security payments as they arise.

In most instances, the proportional reduction in prices exceeds the reduction in revenues because of some upward revisions the Commission has made to the water businesses' forecasts of growth in water consumption over the next five years (chapter 10).

**TABLE 3 AVERAGE PRICE INCREASES PROPOSED BY WATER BUSINESSES**  
Compared with draft decision — average 2013-14 to 2017-18

	Proposed by business	Draft decision	Difference
City West Water	31.7	20.6	-11.1
South East Water	34.9	24.8	-10.1
Yarra Valley Water <sup>a</sup>	35.8	25.8	-10.1
Western Water	35.6	5.9	-29.8

<sup>a</sup> Prices shown for Yarra Valley Water are indicative because the business has proposed a revenue cap form of price control. Maximum allowable prices may change during the regulatory period.

Melbourne Water provides waterways and drainage services to end use customers. The business has proposed to increase prices for those services by 14.1 per cent over the next 5 years. The Commission's draft decision is to allow these prices to increase by 0.5 per cent over the regulatory period.

**TABLE 4 WATERWAYS AND DRAINAGE PRICES PROPOSED BY MELBOURNE WATER**  
Compared with draft decision — average 2013-14 to 2017-18

	Proposed by business	Draft decision	Difference
Waterways and drainage	14.1	0.5	-13.6

## HOUSEHOLD BILLS AND CUSTOMER SUPPORT

The revised tariffs proposed in this draft decision imply that increases in household water and sewerage bills will be less than those sought by the businesses in their Water Plans. Table 5 compares indicative bills for owner-occupiers in 2012-13 and 2017-18, based on the prices proposed by the businesses and prices resulting from the Commission's draft decision. Table 6 compares indicative bills for tenants. These illustrative bills shown are based on typical consumption figures for owner-occupiers and tenants serviced by each water retailer. Outcomes will vary for individual customers.

Because the Commission proposes to approve Yarra Valley Water's proposal to adopt a revenue cap as its price control mechanism, the prices shown in tables 5 and 6 for that retailer may change slightly, but by no more than its rebalancing constraint of 2 per cent.<sup>2</sup>

<sup>2</sup> The Commission also proposes to approve South East Water's proposal to adopt a tariff basket, subject to the business providing more information about its tariff strategy in response to this draft decision.

**TABLE 5 ILLUSTRATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS<sup>a</sup>**  
\$2012-13

	Current bill 2012-13	Bills based on businesses' proposals		Bills based on draft decision	
		2013-14	2017-18	2013-14	2017-18
City West Water	844	1 085	1 085	989	989
South East Water	858	1 160	1 160	1 071	1 071
Yarra Valley Water <sup>b</sup>	970	1 301	1 301	1 204	1 204
Western Water	991	1 053	1 356	998	1 033

**Note:** real values. <sup>a</sup> Based on the businesses' proposed prices and draft decision prices. Bills are calculated using each business's average consumption. Bills are based on average consumption of: CWW (149kL per annum), SEW (148kL per annum), YVW (161k per annum), WW (189kL per annum). <sup>b</sup> Bills shown for Yarra Valley Water are indicative because the business has proposed a revenue cap form of control, prices may change during the regulatory period.

**TABLE 6 ILLUSTRATIVE ANNUAL RESIDENTIAL TENANTS BILLS<sup>a</sup>**  
\$2012-13

	Current bill 2012-13	Bills based on businesses' proposals		Bills based on draft decision	
		2013-14	2017-18	2013-14	2017-18
City West Water	457	595	595	542	542
South East Water	440	618	618	571	571
Yarra Valley Water <sup>b</sup>	528	727	727	672	672
Western Water	280	305	436	289	328

**Note:** real values. <sup>a</sup> Based on the businesses' proposed prices and draft decision prices. Bills are calculated using businesses' average consumption. Bills are based on average consumption of: CWW (149kL per annum), SEW (148kL per annum), YVW (161k per annum), WW (189kL per annum). <sup>b</sup> Bills shown for Yarra Valley Water are indicative because the business has proposed a revenue cap form of price control, prices may change during the regulatory period.

The Commission's draft decision to moderate price increases will go some way to addressing concerns about affordability. Nonetheless, the Commission has encouraged all water businesses to put in place measures to support customers who may have difficulty paying their bills and the Commission will continue to monitor and report on the implementation of these measures. The Commission also proposes to allow an additional \$5 million for the metropolitan retailers in

2013-14 to help them assist customers in managing the impact of the proposed price increases. These businesses are required to demonstrate to the Commission how they have used the funds to specifically improve support for low income and vulnerable customers experiencing hardship.

